

Office of Chief Counsel
Internal Revenue Service

memorandum

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KEChandler

date: **JAN -7 2000**

to: Chief, Examination Division, Virginia-West Virginia District
Attention: Richard J. Guastello, Case Manager, 1112
Fred Heggi, International Examiner

from: Associate District Counsel, Delaware-Maryland District,
Washington, D.C.

subject: [REDACTED]
Source Allocation of Charitable Contribution Deductions

This is in response to your request for advice regarding the proper allocation of charitable contribution deductions between U.S. and foreign source income. You currently have under examination the consolidated income tax returns filed for the calendar years ending December 31, [REDACTED], December 31, [REDACTED] and December 31, [REDACTED].

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ISSUE

What is the correct method for allocating charitable contribution deductions between U.S. and foreign source income?

FACTS

On its 1120 for [REDACTED] and [REDACTED], [REDACTED] ("[REDACTED]") treated all of its claimed charitable contributions as U.S. sourced. That sourcing was based on the fact that the charitable organizations receiving the charitable contributions were located in the United States. [REDACTED] now concedes that a minuscule percent of its charitable contributions for [REDACTED] and [REDACTED] should be allocated to foreign source income because the [REDACTED], a U.S. based foundation, made a small percentage of its grants to foreign charities. Based on the grants of the [REDACTED], [REDACTED] also asserts that a similarly insignificant portion of its [REDACTED] charitable contributions should be foreign source. [REDACTED] currently asserts that the following sourcing allocation is appropriate based on the U.S. location of the majority of its charitable contribution recipients:

	[REDACTED]	[REDACTED]	[REDACTED]
Foreign Sourced	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]
Domestic Sourced	[REDACTED]	[REDACTED]	[REDACTED]
Total Charitable Contributions	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]

In contrast to [REDACTED]'s allocation, the International Examiner responsible for this issue asserts [REDACTED]'s charitable contribution deductions should be allocated based on [REDACTED]'s gross income from U.S. and foreign sources. Such allocation would result in the following:

	[REDACTED]	[REDACTED]	[REDACTED]
Foreign Sourced	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]
Domestic Sourced	[REDACTED]	[REDACTED]	[REDACTED]
Total Charitable Contributions	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]

As reflected in the following table, as percentages of the total charitable contribution deductions allocated to Domestic sources, [REDACTED]'s allocation is in stark contrast to that proposed by the International Examiner:

	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]'s Allocation to Domestic Sources	[REDACTED]%	[REDACTED]%	[REDACTED]%
IE's Allocation to Domestic Sources	[REDACTED]%	[REDACTED]%	[REDACTED]%

Using a thirty-five percent tax rate, the International Examiner's proposed reallocation of [REDACTED]'s charitable contribution deductions would result in the following estimated additional tax for the years currently under examination:

Additional Tax

[REDACTED]	\$ [REDACTED]
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Total \$ [REDACTED]

DISCUSSION

Section 861(b) of the Internal Revenue Code entitled "Taxable Income from Sources within United States" provides:

From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. ...

Section 1.861-8, Income Tax Regs., concerns computation of income, including the allocation and apportionment of deductions, from sources within the United States as well as foreign sourced income. Treas. Reg. § 1.861-8(a)(2) provides that "allocations and apportionments are made on the basis of the factual relationship of deductions to gross income." Treas. Reg. § 1.861-8(b) specifically considering allocation of deductions provides, in part:

(1) ... Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income ... Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions are related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income (See paragraph (e)(9) of this section.) ...

(2) ... A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. ...

* * * *

(5) ... If a deduction does not bear a definite relationship to a class of gross income constituting less than all of gross income, it shall ordinarily be treated as definitely related and allocable to all of the taxpayer's gross income except where provided to the contrary under paragraph (e) of this section. Paragraph (e)(9) of this section lists various deductions which generally are not definitely related to any gross income and are ratably apportioned to all gross income.

Treas. Reg. § 1.861((e)(9)(iv) explicitly identifies charitable contributions as part of the group of deductions which "shall generally be considered as not definitely related to any gross income". Consequently, deductions for charitable contributions are generally apportioned ratably between U.S. and foreign sources in accord with Treas. Reg. § 1.861-8(c).

In March 1991 regulations were proposed which would have altered the general rule for allocation of charitable contribution deductions set forth above. The proposed regulations would have permitted allocation of a deduction for charitable contributions solely to U.S. sources if the taxpayer both designated the contribution for use solely in the United States and reasonably believed that the contribution would

be so used. The 1991 proposed regulations have not been adopted. As recognized in Garvey, Inc. v. United States, 1 Cl.Ct. 108, 118 (1983), aff'd, 726 F.2d 1569 (Fed. Cir. 1984), which considered the weight to be given proposed regulations amending existing regulations:

As the term itself makes clear, proposed amendments are merely preliminary proposals. They are published in the Federal Register pursuant to the Administrative Procedure Act, 5 U.S.C. § 553, in order to give notice to the public of a proposed regulation that is under consideration. But there is nothing that requires the government to adopt in final form a regulation published as a proposed amendment, particularly when, as here, a valid regulation that deals with the subject already is in effect.

██████ asserts that the use of the word "generally" in Treas. Reg. § 1.861-8(e)(9) "clearly indicates that certain charitable contributions may nevertheless be allocated entirely to U.S. source income if the contribution is definitely related to a specific class of income." ██████ elaborates on this assertion as follows:

Thus, both the regulations currently in effect and the proposed regulations strongly reject the notion that a gross-to-gross allocation is the exclusive allocation rule. Taxpayers are clearly permitted to allocate contributions entirely to U.S. source income [in] cases where the contribution is more properly associated with the taxpayer's U.S. activities and gross income.

* * * *

Accordingly, we believe that current law clearly permits, and tax policy considerations compel, a direct allocation of charitable contributions to either U.S. source income or foreign source income ... on the basis of the general rule set forth in Treas. Reg. § 1.861-8(a)(2).

Contrary to ██████'s assertion, the regulations in effect applicable to the allocation of charitable contribution deductions mandate allocation of those deductions to all of ██████'s gross income. This is the position advocated by the International Examiner.

CONCLUSION

District Counsel agrees with the International Examiner that [REDACTED]'s charitable contribution deductions for the years currently under examination should be allocated to all of [REDACTED]'s gross income.

This advisory has been reviewed by the National Office. If you have any question regarding this memorandum or wish to discuss the issues further, please contact Karen E. Chandler directly at (202) 634-5403, ext. 224.

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